Lima, October 27 2010

OFICIO Nº 083 -2010-EF/93.01

Mr. Robert Garnett,
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
***United Kingdom**.-*

Dear Sir:

We noted that the IFRS Interpretative Committee in its September 2010 meeting, decided not to add to its agenda the matter related to "IAS 19 Employee Benefits – Accounting for a statutory employee profit sharing"; because it´s concluded that the deferred effects of employees profit sharing schemes must not be recorded, taking into consideration for its conclusion that the employees benefits for future services must not be recorded.

In Peru we have a profit sharing scheme similar to the Mexican one which was already presented to the IFRS Interpretation Committee and we believe that the accounting treatment in accordance with IFRS must be to record the deferred effects as further explained below. Please take into consideration that we discussed this matter with the Mexican Financial Reporting Standard Board (MFRSB) and we share with them the key concepts in relation to this matter.

1. Nature of the employee profit sharing payment

The employee profit sharing payment is composed of two items. One is represented by outflows of resources that will occur in the year subsequent to that of the related taxable income, and the other is represented by outflows or inflows of resources that will occur in future years as the temporary differences, which reduced or increased the current year taxable income, reverse. The future outflow or inflow is a legal right enforced by law.

For instance, if an entity took accelerated depreciation of equipment for tax purposes, taxable income will increase in future years vis a vis book income, since a portion of the book depreciation will not be deductible. Therefore, as outflows of resources will occur to settle a present obligation arising from past events (the effect of the reduction in taxable income); it is clear that a liability exists. Also, if an entity provide for an account receivable for financial purposes, such provision will be deductible in future years and an asset exist, as defined in paragraph 53 of the Framework for the Preparation and Presentation of Financial Statements (hereinafter "the Framework"): "The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production".

Another way to look at it, is as a past event in which the employees helped create income in a given year, which generates employee profit sharing. However, due to the provisions of the tax law, a portion of taxable income is deferred and, as a result, a portion of the payment of employee profit sharing will also must be deferred until it is included in the taxable income of a future year. Therefore, the employees, as a group, see more details in point 3 below), have already earned the profit sharing that will be paid in future years and it is recognized and enforceable by the Peruvian Legislation.

Accordingly, a liability for deferred employee profit sharing exists, based on the definition of a liability in IAS 37, as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits." Also, an asset exists as similar definition is included in paragraph 58 of the

Framework: "The assets of an entity result from past transactions or other past events…" which is clearly the case of the Peruvian employee's profit sharing scheme, which as mentioned above is supported and enforced by law.

2. Accrual or provision

As discussed in paragraph 11 of IAS 37, "accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees." It could be considered that due to the fact that the existence of future taxable income is uncertain in certain degree (it is important to consider that IFRS assume no going concern issues), deferred employee profit sharing payable should not be considered an accrual but it is clear that it should be a provision, hence a liability, as indicated in paragraph 13(a) of IAS 37, which states that provisions "are recognized as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations…"

Based in paragraph 14 of IAS 37, we can conclude that:

"A provision shall be recognized when:

(a) An entity has a present obligation (legal or constructive) as a result of a past event;" - The legal obligation exists to pay the deferred employee profit sharing when the temporary items reverse and the event that created the income is a past event as indicated above;

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and" - As indicated in paragraph 17 of IAS 37, "A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the "case only ….where the settlement of the obligation can be enforced by law." The obligation to pay employee profit sharing is established by the Peruvian law; therefore, it is clear that, when future taxable income includes the temporary items that reverse, the payment will be enforced by law;

(c) A reliable estimate can be made of the amount of the obligation." – The estimate can be made based on the temporary items that resulted in the deferral of taxable income and, therefore, employee profit sharing, at a rate of 10%.

Regarding the possible outflow, we have to consider what is indicated in paragraph 23 of IAS 37, which states that "For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purposes of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e. the probability that the event will occur is greater than the probability it will not." In this regard, we believe that the probability there will be taxable income in the future is greater than the probability there will not for all entities that are on a going concern basis; also, a reliable estimation can be made and is required by IFRS.

The same analysis is applicable for the recognition of the asset side, based on paragraphs 53 and 58 of the Framework as explained above, which, in our opinion, is subject to the recognition criteria established in IAS 12.

3. Employee group as a whole

As we discussed, the employee profit sharing to be paid to employees is determined based on a percentage of taxable income. Such amount is payable to the employee group as a whole. In the first step of the computation, which is the one that entails accounting issues, the amount payable to each employee is not yet determined. That will be made in a second step, through an arithmetic computation based on salaries and days worked by each employee, to distribute the amount determined in the first step. Therefore, this second step does not pose any accounting issues.

Therefore, to determine the expense, it is necessary to consider that employee profit sharing is payable to the group of employees who will be working in any given year. Consequently, the employee profit sharing that was generated by creating wealth in a specific year is payable to the employees working at the entity in future years. These employees may not be those that were working when the wealth was generated, due to normal employee turnover at entities, since it is paid to the employee group working in the entity at the time of payment.

As in the case of income tax, the payment to the government is deferred and, in the case of employee profit sharing, the payment to the employee group as a whole is also deferred. It is not an employee-by-employee computation in the first step, as indicated above, but to a group of employees.

In this respect, IAS 37 does not require knowing the identity of each the employee to record a liability, and paragraph 20 indicates: "An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed-indeed the obligation may be to the public at large". In the case of employee profit sharing, the obligation is to the employee group as a whole.

4. Measurement issue

The recognition of employee profit sharing has two issues:

(i) the presentation in the income statement and

(ii) its measurement.

The presentation must be as an operating expense as prescribed by IAS 19. Regarding measurement, the problem is whether IAS 19 should be used or if instead IAS 12 should be used.

The principle underlying IAS 12 is that the deferral does not mean that an expense does not exist for the amount being deferred, but that an expense has to be recorded for such liability that will generate cash outflows in the future. We believe that this same principle should apply when an amount of employee profit sharing is deferred and will generate cash outflows when later paid to the employees as a group.

In our opinion, IAS 19 was developed considering employee benefits that an entity agrees with its employees as a result of negotiations held with them, such as pensions, or due to laws that establish certain benefits such as vacation pay, maternity leave, etc.

However, IAS 19 does not consider an employee benefit based on taxable income, which in its beginning was on split of the amount paid to the government in two parts:

(i) One for government use and

(ii) Second, for the employees.

As result, IAS 19 should not be considered the standard applicable to the measurement of this liability or asset, as its nature and substance is similar to a tax obligation, only with different beneficiary.

We believe that the measurement of an expense derived from a taxable profit determined on what is prescribed by an income tax law should be based on IAS 12, irrespective if the amount is to be paid to the government or to the employees, since it is the only way to make the reasonable estimate requested by paragraph 14(c) of IAS 37. This will result in consistent measurement of the effect of deferred items in both cases, since recognizing them in one case and not in the other would represent inconsistent application of a principle.

Conclusion

We understand the IFRS Interpretations Committee assessed how statutory employee´s profit sharing schemes should be presented and measured, but did not assess if the deferred portion represents a liability or asset. We believe that as the deferred portion of employee profit sharing "is a present obligation of the entity arising from past events, the settlement of which is *expected to result in an outflow from the entity of resources embodying economic benefits", it is indeed a liability as defined by IAS 37, and considering that the base to compete such benefit is taxable income; it is also possible to have an asset as defined on paragraphs 53 and 58 of the Framework.*

The fact that the deferred employee benefit is not an income tax does not change its nature as a liability or asset; for such reason, in our opinion, based in the principles of the IFRS, such liability or asset should not disappear from the statement of financial position simply because the standard for employee benefits does not deal with statutory employee profit sharing based on taxable income.

Based on the analysis presented above, we strongly suggest that the tentative decision reached by the IFRS Interpretations Committee should be revised in order to determine if they agree with us that there is a liability or asset, which should be recognized.

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If you require additional information related to this letter, please contact Mr. Juan Paredes Manrique, Vicepresidente del Instituto Peruano de Auditores Independientes, phone: 051-1411-4444, mail: juan.paredes@pe.ey.com, respectively.

Sincerely,

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